DOW THEORY LETTERS INC.

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Registered with the Securities Exchange Commission

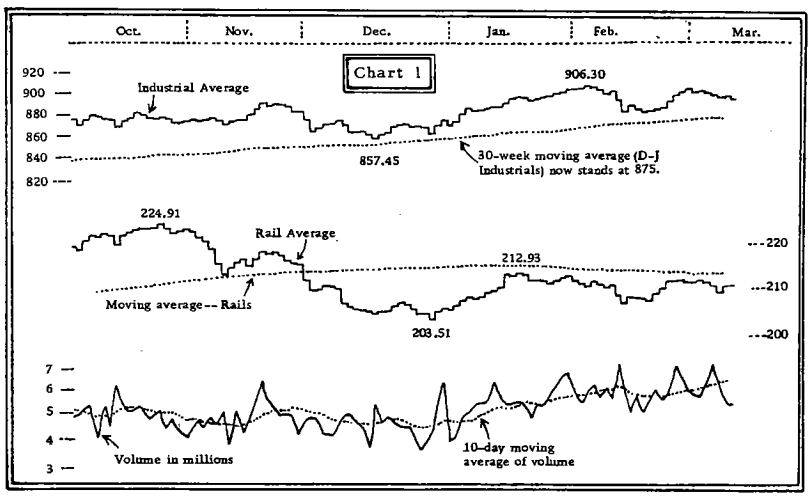
40 Letters per Year — $50.00 Annually

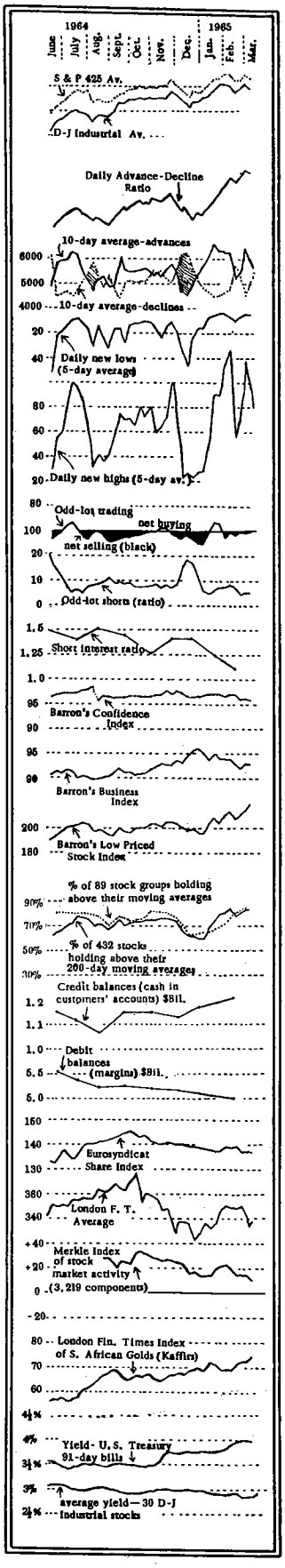
March 11, 1965 Letter 282

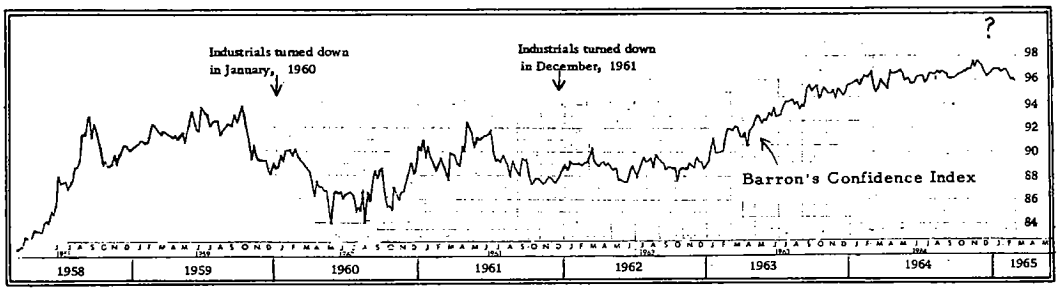
THE MARKET: The current market profile is, in my opinion, both exciting and puzzling. As things stand now we are witnessing a prolonged and persistent divergence in the two Averages accompanied by high volume. Note on Chart 1 that the Rail Average recorded its bull market high in October at 224.91. In November Industrials rose to a new high, but Rails established a lower peak. In January, 1965, the Industrials rose to another historic high while Rails set a third descending peak of 212.93. Again in February Industrials advanced to an all-time high of 906.30, and a fourth descending peak was recorded by Rails. During the most recent (March) period the two Averages have merely been "churning" under their February highs.

Conclusion: There is no questionning the fact that the long period of divergence (since October) is suggestive of distribution. The extremely high average volume of the past five months, volume which failed to exert any particular "lifting power" under the Averages, also hints of distribution. Nevertheless, from the standpoint of orthodox Dow Theory, a trend is conceded to remain in force until proved otherwise. The bear points for the Averages are the 857.45 and 203.51 levels of December. As long as one or both Averages hold above those points, the bull trend should be considered to remain intact.

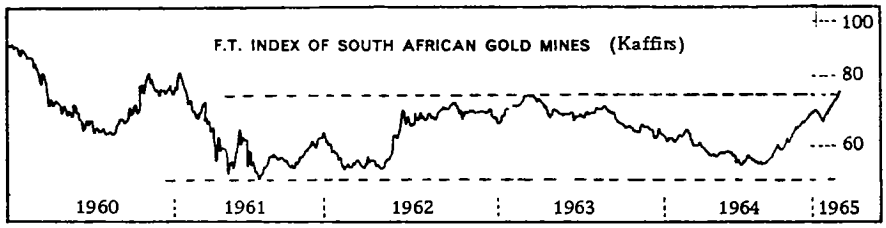
Composite Chart: Divergence seems to be the order of the day. One of the most interesting and unusual developments of the past five weeks has been the consistently superior performance of the A-D ratio as compared to the D-J Industrial Average. This is another way of saying that the majority of issues have been tending to move higher while the "giants," the stocks that make up the Industrial Average, have refused to confirm. The Industrials and the A-D ratio touched highs on February 3 (Industrials 906.30). New highs were subsequently recorded by the A-D ratio on February 26 (Industrials 903.48) and March 3 (Industrials 900.76). This type of "triple divergence" (with Industrials failing to confirm the breadth) is seen but rarely, although it did occur in early 1934 and again in early 1953. Both of those divergences resulted in severe and prolonged market reactions (but not bear markets). In the present instance, I feel that broad market weakness may again be seen if Industrials continue their weak action in the face of the stronger A-D ratio. One of the more hopeful signs so far is the low level of daily new lows, which are holding around the 5-7 area. Barron's Confidence Index dropped to 95.9 this week, thereby sinking to its lowest level in a year. This is the first apparent "breakdown" of the C. I. since 1962, and it does not bode well for the Industrial Average. So that subscribers may study this situation more carefully, I have included an eight-year chart of the C. I. (page 2) with arrows indicating the points at which the Industrial Average "topped out." The percentage of stocks holding above their moving averages held at 81% this week, still a picture of strength. The Merkle Index dropped to 10, its lowest level since 1962 (but the Index is still above zero, the critical level). The S. African gold index (Kaffirs) "broke out" above its 1963 high of 74 this week (chart Page 2), thereby climbing to a four year high. The whole 1961-64 period is beginning to look like a massive base for the Kaffirs, and as predicted in Letter 276, this group is beginning to gather investment status. A great many subscribers have written to tell me that they have positions in such recommended issues as President Brand, Free State Geduld, Welkom, Western Deep Levels, Blyvoors. These subscribers are now enjoying profits of from 10 to 25% (plus fat devidends). The long-term chart of the Kaffirs suggests that we may have bought near the bottom of what could be a major (primary bull)





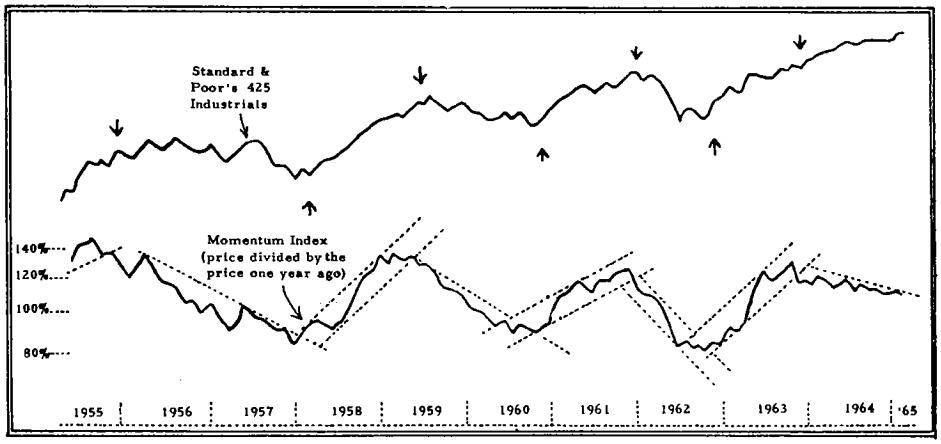


movement in these stocks, and I suggest that subscribers hold all their S. African golds (even buying more in this area). It is slowly dawning on investors that the Kaffirs will be first to gain from a British devaluation (since the S. African rand is directly tied to the pound; (two rands equal a pound), and the Kaffirs Index seems to be rising in direct ratio to the deterioration in the British balance-of-payments. Barron's (March 8), undoubtedly the most influential investment periodical in the nation, has come out with a "lead-off" article on the S. African golds this week, and I urge all my subscribers to study this article (first of a two-part series).



MOMENTUM: Letter 253 introduced subscribers to the Momentum Index, and since then I have attempted to include monthly comments regarding the changes in this Index. Analysts make use of a variety of indicators with which to measure the momentum of stock averages. Most of these devices are based upon changes (in percentages) of a given stock average over a specific period of time. Personally, I have found that valuable inferences can be drawn from the action of the broad Standard & Poor 425 Industrial Average when its price at the end of each month is charted as a ratio of its price exactly one year ago.

The accompanying chart traces this action from 1955 to the end of February, 1965. As long as the Index is above 100% we know that the price of the "425" is higher than it was one year ago (the contrary is true when the Index falls under 100%). The really important thing to watch, however, is the trend of the Index or the upward or downward momentum. Note that the Index tends to form well defined channels. A penetration above or below the channel by the Index seems to indicate a change in momentum. The arrows on the chart show where definite channel penetrations (up or down) have occurred.



The record of this Index has been fairly good, and it has proved its usefulness on numerous occasions. Most signals have been followed by changes in market direction within a few months, although very premature signals came in 1951 and 1955. In 1951 the Index turned lazily down a full 18 months ahead of the final 1953 peak in the 425. In 1955 the Index broke in May, 14 months ahead of the final 1956 peak in the 425.

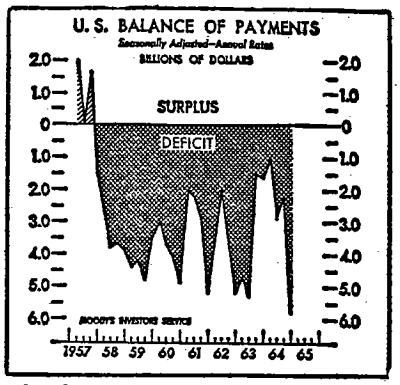
The most recent signal was given by the Index when it broke its upward channel in November, 1963. Sixteen months have elapsed since then, and although the S & P Average (see chart) seems to be flattening out, it has not yet turned down. The latest (end-of-February) figure for the Index was 112, a new low. Based on the extended time element of 16 months, I would now expect one of the following two contingencies to occur: (1) the market will run into serious trouble shortly, or (2) the Index will turn up in the next month or two, thereby providing a signal for a definite reversal of market momentum to the upside.

GOLDFINGER: It may be that a few years from now we will talk about "the good old days when we owned so much gold that they even made a picture called Goldfinger about an international villain who tried to destroy the huge U. S. gold supply at Fort Knox." But times are changing. In roughly the first two months of 1965 the U. S. has lost over half a billion dollars worth of gold. In the face of this, President Johnson retains a stony silence, Federal Reserve Board Chairman Martin issues warnings while telling Congress that he does not expect "much in the way of an increase in long-term interest rates," and Congressman Patman (leader of the cheap-money forces) berates Martin for not making credit even easier.

As this writer sees it, the current bull market began in a normal and healthy manner during the 1940's. The great boom grew out of the huge pent-up demand which was accumulated during the War years. Around 1959 the bull market and the boom showed signs of "topping out." It was then that the policy of massive inflation of the money supply came to the fore. Our politicians, always quick to capitalize on a "sure thing," recognized a method of keeping the boom (and the votes) going forever. "It's easy," they reasoned, "simply produce deficits, continue printing dollars, keep money cheap and keep spending as fast as Washington can dream up new spending plans." Throughout all history when such policies have been pursued, the last word has been spoken by the money market. And the end has always been the same. The nation's reserves run out, and it then either collapses through inflation or (if the nation attempts to protect its reserves) the boom collapses because of rising interest rates.

The world monetary situation has now entered a remarkable phase. Much of Europe and the world is now in a boom, a boom which has been using dollars for its fuel. In other words, U. S. dollar deficits have been financing the world's prosperity. Many people believe that there is no easy way out of this situation. My friend Eliot Janeway believes that our recent deficits are a bargain compared to what could happen if we cut off the world supply of dollars. For instance, Janeway is of the opinion that the dollars we recently provided bought us a bargain when they held off a collapse of the pound. "If sterling had gone and taken the European boom with it," commented Janeway in his recent report, "the cost to us — in income and tax collections — would have been immeasurably greater. During the height of the sterling crisis, this danger that a depressed Europe would dump us into an earnings squeeze was mainly overlooked. Nevertheless, this has been the big threat to our boom."

This is an interesting thesis. It means that U. S. dollars are indeed necessary to keep much of the world "afloat." But the question is — can the U. S. continue to inflate and run deficits without facing a massive run on the dollar? It seems to me that Europeans (particularly the Common Market nations) are signifying that they are now willing to face deflation rather than more inflation. Furthermore, I believe that the U. S. is nearing that precarious point at which its gold losses are beginning "to feed on themselves." As our gold stockpile dwindles, each central banker (both inside and outside the Common Market) must feel it incumbent upon himself to raise his own gold-to-dollar ratio "just a little bit higher." With the price of gold going up weekly and with massive amounts of gold going into private hoarding, it is becoming a scramble to see how much of the yellow metal each individual and each nation can put away at "the current bargain price of $35 per ounce."



When our Administration recently removed the 25% gold backing from the commercial bank reserves they stated that this would increase confidence in the dollar because so much more gold would now be available for foreign claims. If there has been any increased confidence in the dollar over the past few months, it has completely escaped this writer. Foreign nations receive a fat rate of interest on dollars held here, but they receive no interest on gold. The half billion dollars in gold that has been pulled out of this country in the past two months hardly bespeaks confidence. As a matter of fact it smacks very plainly of growing fear (along these lines the chart of the U. S. quarterly balance-of-payments needs no comments, but it is worth studying carefully).

Of interest is the fact that statistics now show that foreigners are sellers of U. S. securities on balance after many years of net buying. Such sales are turned into dollars which are then potential gold claims. Also of interest is the breakdown of fourth quarter gold withdrawals from the U. S. "Significant purchases of U. S. gold were made in the quarter by several nations that hadn't been active customers for U. S. gold earlier last year," (from Wall Street Journal, March 8). Among the new takers: Belgium and Holland.

NOTE: My efforts to pack as much information as possible into these Letters may require that subscribers purchase magnifying glasses (and I am serious), but it will be worth it. This clip from the March 2 (London) Economist is fascinating, and it shows how little publicity unpleasant stories receive in our press! By the way, The Economist provides the finest international financial news coverage of any publication in the world (price to U. S. via airmail, $35, 25 St. James St., London S. W. 1).

Germany Out of Dollars

But this is a time for keeping a watchful eye on the balance sheets of central banks. The latest report of the German Bundesbank, which has traditionally been most helpful to the dollar, shows that in just over a year its holdings of ordinary short-term dollar balances have been abruptly halved, and at $1.3 billion at end-January were little larger than those of France. This switch, which has reduced the percentage of these risk-bearing dollars to the Bundesbank's total reserves from 36 to 18 per cent, has been achieved partly by exchanges into American Treasury bonds ("Roosa bonds") denominated in D-marks, but also by an equivalent increase in gold holdings. Germany has taken care to arrange its switch out of dollars quietly, with the minimum disturbance to exchange markets; but the scale of the switch has in fact been notably larger than, for all the noise, that undertaken so far by France.

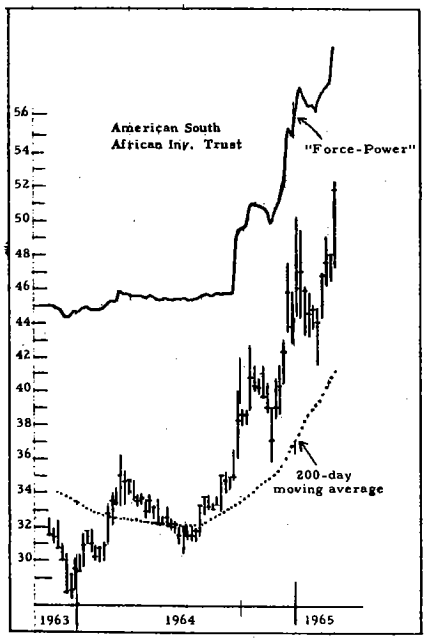
On this side of the Atlantic, The Wall Street Journal and Barron's are "musts" for all investors. I also feel that of the major mass consumption magazines, U. S. News and World Report does the best job of reporting with least wishful thinking and pap. Time Magazine is usually interesting but they "rehash" (very little reporting) and they are (in my opinion) particularly dreary in their economic reporting (they tend to push the inflationist views). Newsweek presents much more in the way of fact, and when they editorialize they usually say so. Newsweek does do some original financial reporting at times such as their periodic survey of projected capital spending. Business Week is the "executive's happy handbook," sometimes helpful but sometimes late with the real story. Business Week (unlike U. S. News) tends, in my opinion, to avoid the unpleasant or at least not to cover it until it is "old hat."

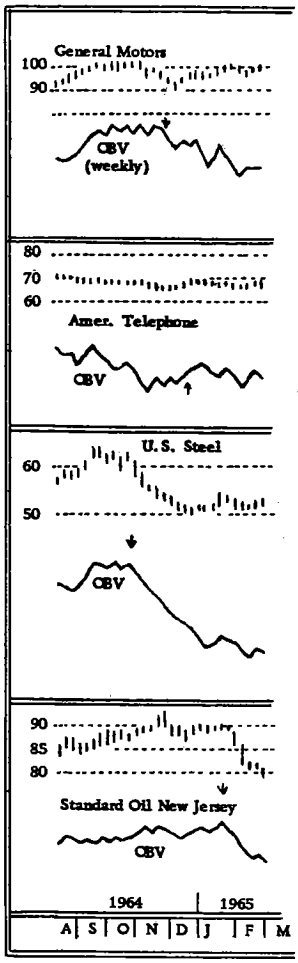
STOCKS: Chartcraft lists the following as the strongest groups on the Board in this order (1) Radio-TV Broadcasters, (2) Brewers, (3) Apparel Mgs., (4) Metal Fabricating, (5) Steam Generating Mach. The five weakest groups are Paper, Motion Pictures, Soaps, Crude Oil Producers and Banks (outside N.Y.C.).

In Letter 277 I introduced readers to Joe Granville's concept of on-balance volume (OBV). Granville's thesis is that volume precedes price, and that a running (plus or minus) tabulation of volume will show "where the money's going" in a given stock. Thus a running total (as in the A-D ratio) of volume is tabulated daily (or weekly). I included charts in Letter 277 showing price and weekly OBV in four of the issues which account for a huge percentage of this nation's business. It might be interesting to up-date these charts in this Letter (see Page 4). In each case, the OBV protrays distribution, and this may give us an insight into the current lagging performance of the D-J Industrial Average. General Motors hit its peak on October 6, and it has now been five months since this issue recorded its high. GM (historically) has tended to turn down before the general market; consequently, it will be particularly interesting to see whether this important stock can better its all-time high of 102 5/8. It is of interest that the Auto group is now 78 on Chartcraft's list of 89 stock groups. The "Big Three" auto companies are all showing deteriorating relative strength on the Traders Research charts, and I now feel that the Auto stocks should be sold (despite all the glowing auto statistics!).

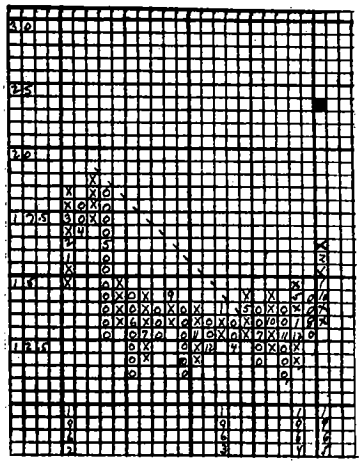
A refinement of the Granville OBV technique has been worked out by my good friend Fred Whitmore at San Diego's Paine, Webber office. Whitemore uses a line which reflects both pointage and volume (weekly), and we have been getting some remarkable

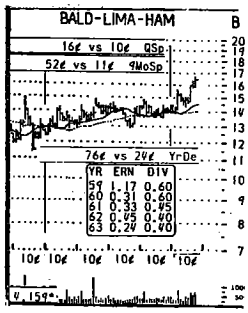
results from this method which we call "Force-Power" (the exact formula for which I am not at liberty to disclose). I include a chart of American South African, a stock which has been recommended here ad nauseum, and still one of the strongest issues on the Exchange. Note the strength of the Force-Power line during most of 1964 while the price of ASA was declining. This "divergence" was a sign of great strength. Also note the persistent rise of the Force-Power since late-1964 to its recent new high. It is obvious that the strength in ASA is continuing.

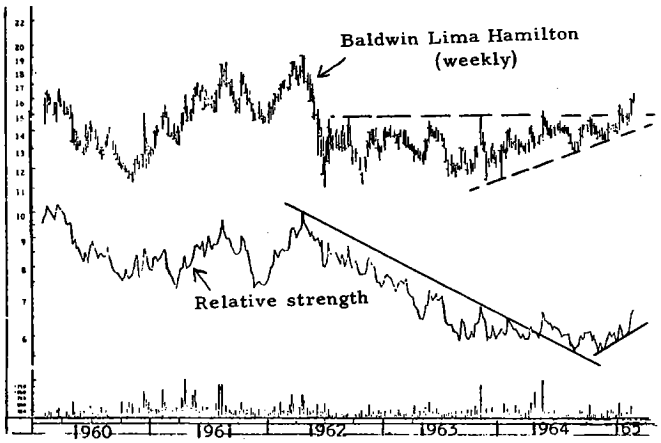




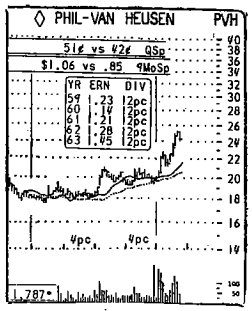
BALDWIN-LIMA-HAMILTON (B)





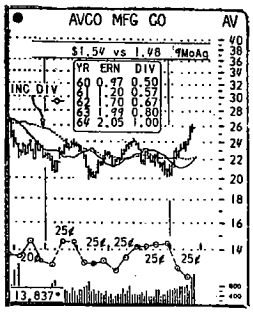


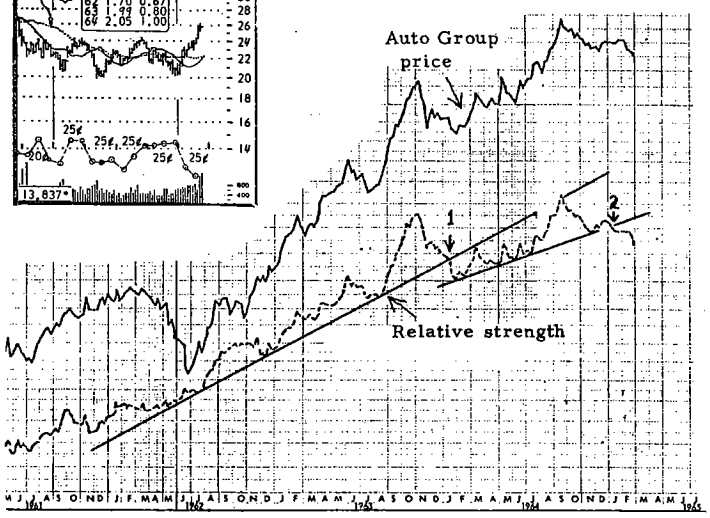
I am very hesitant about recommending new stocks here, but one which shows up well from every direction is Baldwin Lima Hamilton. This stock produced new highs in Force-Power in late 1964 and its Force-Power line is now at a new high. As seen on the chart, B has pushed out of a large ascending triangle while its relative strength line has now reversed a two-year downtrend. The Point & Figure chart of B shows a beautiful base with a breakout at 15. The base is large enough to take this stock to 24 (black square).



Most of my recent recommendations are holding well in a difficult market. These include Avco (acting very well), Phillips-Van Heusen, Amphenol-Borg, Crowell-Collier, Gulf-American Land, Symington-Wayne, and Food Fair.

Relative Strength: Because auto sales and production is the biggest "kicker" in the U. S. economy today, I am dwelling at length on this group. The following will constitute a "test" of the worth of relative strength (R. S.). Note that the Auto group followed a rising trend of R. S. from 1961 to 1964. In 1964 (arrow 1) the group's R. S. turned down. A secondary rising trendline was formed, but two months ago the second R. S. trendline was broken (arrow 2). The R. S. study is saying that the Auto group is decisively turning down in popularity, and that investors see something ahead which is causing them to move out of Auto shares. I believe we will see more obvious confirmation of this in the price of auto stocks over the period ahead.





Charts of Auto Group, Confidence Index and large weekly bar chart of Baldwin courtesy of Traders Research, 1431 Pearl St., Alton, Illinois. P & F chart of Baldwin courtesy of Chartcraft, Inc. Larchmont, New York. Small weekly charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.